R 4105-68 p (A)

The Conference Board

Economic Analysis Program

World Economic Monitor

Volume 2, Number 3 Summer 1987

AFTER THE VENICE SUMMIT

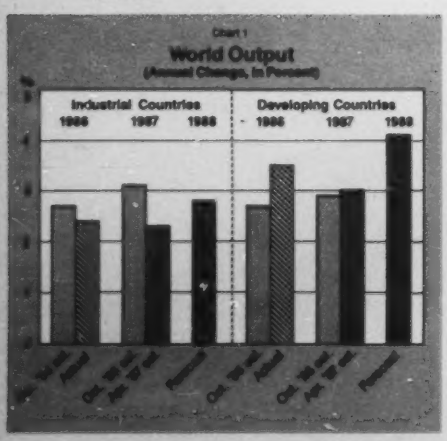
> The crucial decisions are taken domestically. . .To the extent that we can attribute responsibility, the challenges that we are now facing among both industrial and developing countries are the result...of mistakes made at the national level.
>
> John W. Crow, Governor
> of the Bank of Canada,
> April 27, 1987

Beginning with the declaration of the Tokyo economic summit of 1986 right through this year's summit in Venice, all high-level international economic and financial meetings have stressed the importance of international policy coordination in sustaining world economic activity. No one will deny that the benefits of a global economy and of international trade and investment would be lessened, if not lost altogether, if the major countries were to pursue diametrically opposed policies—or, in the words of the International Monetary Fund, policies that are "inadequately harmonized."

This truth has come to be recognized even in the United States. In discussing the adverse effects that a further decline of the dollar might have on the U.S. economy, the Federal Open Market Committee at its March 31 meeting recognized "that the problem was multilateral in nature and that the effectiveness of any policy steps in the United States would be greatly enhanced by complementary actions abroad."

But policy coordination—or at least some form of cooperative effort—will have to differ, depending on the circumstances. At the moment, world economic prospects look none too robust; the scope for policy coordination appears somewhat limited; and the much-touted use of indicators to monitor countries' economic performance is nowhere near implementation.

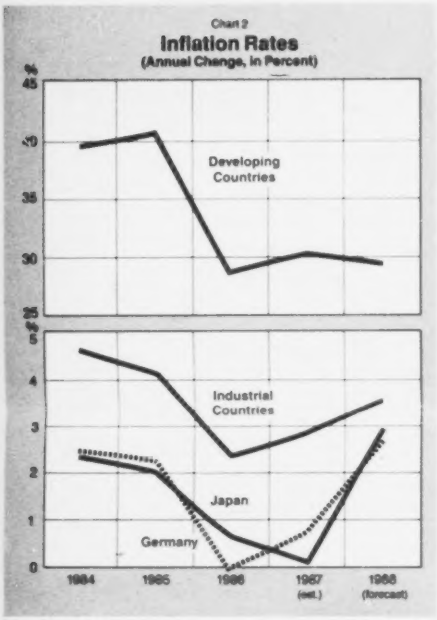
Only Modest Growth Ahead



As of the spring of 1987, the economic outlook for the industrial countries—and hence for the world economy as a whole—looks somewhat less promising than it did some six months earlier (Chart 1). The International Monetary Fund, for instance, foresees "some moderation in the overall pace of domestic demand expansion." Until quite recently, it had been anticipated that this weaker rate of growth might be counterbalanced to some extent by renewed import growth in the developing countries. However, recent developments in the debt situation—the partial write-off of third-world loans by major banks and hence the prospect for less bank lending—may well put a damper on third-world growth as well.

The downward revision of industrial-country prospects for 1987 reflects a number of factors. Investment spending was hit hard last year in a number of countries and is unlikely to recover in 1987. In the United States, capital expenditures have been adversely affected by the curtailment of tax incentives and, more recently, by rising interest rates. In both the United States and Canada, expenditures were also held down by the sharp decline in oil prices. In other major countries with large export sectors—especially Germany and Japan—investment plans were scaled back promptly in response to the

Copyright © 1987 by The Conference Board, Inc.



appreciation of their currencies, and growth of demand and output declined fairly rapidly.

On the policy side, financial policies in general are somewhat more restrictive this year than in 1986. In most countries, fiscal policy is less likely to supply a stimulus to business activity, especially at the central government level. And the general easing of monetary conditions that had characterized 1986 is unlikely to recur this year—it may even be reversed, as has already been the case in the United States.

While inflation will largely remain under control in 1987, prices are likely to accelerate somewhat, although inflation rates in general should remain low by historical standards (Chart 2). In the first place, the one-time effect of last year's sharp drop in both oil and commodity prices will not be repeated. Indeed, many observers expect $18 per barrel to be the most likely price for oil this year, although some softening may occur in the second half. Second, it is unlikely that other countries' import prices will benefit to the same extent as in 1986 by further dollar depreciation.

It is interesting to note that when non-U.S. groups discuss the 1987 outlook the performance of the U.S. economy and the effects of the decline of the dollar occupy center stage. Barclays Bank, for instance, notes how "the main cause of the disparity in output growth among the major economies has been the change in competitive positions resulting from the dollar's fall," adding that this year foreign-trade performance will be critical to overall output growth for all major countries outside the United States.

The Commission for the European Communities is even more outspoken. It comments that, in assessing its revised forecast for 1987 (Table 1), the rapidly changing external environment remains "a source of considerable uncertainty." The fact that the dollar depreciated more sharply against the European currencies than had been anticipated in late 1986 further damaged the competitive position of European manufacturers relative to those located in countries with dollar-related currencies. In addition, total world trade is likely to expand somewhat less in 1987 than had been hoped for earlier.

Table 1
1987 Economic Indicators for the European Community

	*Real GNP**		*Consumer Prices**		*Unemployment #*	
	Forecast of		*Forecast of*		*Forecast of*	
	10/86	*1/87*	*10/86*	*1/87*	*10/86*	*1/87*
France	2.5%	1.8%	2.3%	2.8%	10.7%	11.1%
Germany	3.2	2.0	1.1	0.8	7.7	7.9
Italy	3.6	3.2	4.0	4.0	12.8	13.7
Netherlands	1.8	1.6	-1.0	-0.8	11.1	11.2
United Kingdom	2.7	2.9	3.9	4.3	12.0	11.3
European Community (12 countries)	2.8	2.3	3.0	3.2	11.7	11.8

* annual change
\# as percent of labor force

Thus, the expected contraction in exports—which in Western European countries make up between 25 and 60 percent of GNP—and the uncertainly "surrounding future developments in the external environment" are the main reasons why economic growth in the Community will be lagging behind North America and Japan for the fifth consecutive year. This downward revision in growth prospects will, in turn, affect the unemployment rate which, for the twelve member countries as a group, is projected to remain largely unchanged from 1985 and 1986.

Limited Scope for Policy Coordination

The debate over policy coordination among the major industrial countries has never made it quite clear whether such action was intended to benefit the world economy as a whole, help reduce the sizable external imbalances of the three major economies, or help stabilize the dollar. The Venice declaration stressed all three goals.

Granted, there now is a firmer commitment by all major industrial countries at least to cooperate on certain aspects of their national policymaking. The clearest instances of such a cooperative effort have been in the exchange-rate area, such as the September 1985 Plaza Accord, which set the stage for a "further orderly appreciation of the main nondollar currencies." In early 1986, there also were two "coordinated" discount rate reductions, the first involving the United States, Germany and Japan, and the second this country and Japan only. Both moves were widely seen as attempts to promote greater dollar stability.

But beyond such specifically targeted actions, commitments by the seven summit countries—as, for instance, in the Louvre agreement of this past February—have simply promised to: (1) reduce government deficits in North America; (2) apply fiscal stimulus in countries that have the leeway to do so; and (3) reduce interest rates wherever this would not risk rekindling inflation.

Such general and largely self-evident actions alone are not sufficient to deal with the major disequilibrium overhanging the world economy—the large U.S. payments deficit and its counterpart, the country's increasing international indebtedness. In the past, a relatively stable dollar *and* a satisfactory trade performance were achieved only when growth in other major industrial countries exceeded that in the United States, as was the case in the 1960s. In the 1970s, both growth rates were fairly similar, but dollar depreciation benefited the trade balance. Between 1982 and 1985, by contrast, U.S. domestic growth exceeded that of the other industrial countries by a cumulative 9.5 percent.

At this particular time, a combination of faster growth abroad and further dollar depreciation would therefore be the most favorable solution to the U.S. payments imbalance. Table 2, prepared by Morgan Guaranty Trust Company, indicates the various estimated combinations that would be required to reduce both the U.S. trade and current-account deficits to below $100 billion by 1989. These estimates suggest that only a further decline of the dollar would achieve that target without, at the same time, requiring unrealistically low growth in the United States or an unrealistically rapid acceleration of foreign growth.

What scope is there for Germany and Japan to boost their growth rates, if only to those projected in the third scenario of the table? Both countries would appear to have some elbow room for fiscal stimulus, since their public-sector deficits have fallen to around only 1 percent of GNP (Chart 3).

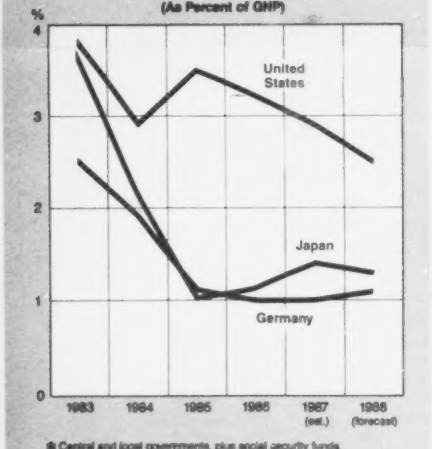
At the beginning of June, the Japanese government announced a $42 spending package—comprising $35 billion in public-sector outlays and a $7 billion tax cut—that eventually would add an estimated 1.6-2.0 percent to GNP growth. But the program's impact on imports, and hence on the country's trade surplus, is expected to be minor. Germany in early May announced a token reduction in the central bank's rate for open-market operations—hardly an economic stimulus—and at the same time made it quite clear that there was "no maneuvering room" for bringing forward or enlarging the tax cuts slated for 1988. Moreover, the drop in both countries' exports will lower their GNP growth by an estimated 1 percent this year.

But while Germany's overall external surplus is projected to decline by some 20 percent between 1986 and 1988, Japan's is expected to fall by no

Table 2
Growth and Exchange-Rate Combinations to Reduce U.S. Trade Deficit to Below $100 Billion by 1989

	End of 1988 Exchange Rates		*Annual GNP Growth, 1987-89*		
	Yen/$	DM/$	Japan	Germany	U.S.
1)	154	1.85	5.4	5.4	1.0
2)	154	1.85	6.3	5.7	2.0
3)	125	1.60	4.3	3.4	2.0
4)	125	1.60	5.5	5.0	3.0

Chart 3
General Government Deficits*
(As Percent of GNP)



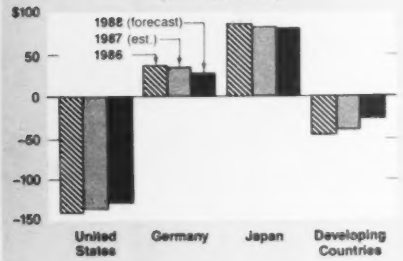
* Central and local governments, plus social security funds.

more than 5 percent (Chart 4). For one thing, Japan's exports are some 80 percent larger than its imports, so that the latter would have to rise sharply to make a major dent in the surplus. Second, by having become the world's largest creditor nation—with net external assets of $180 billion an the end of 1986—increasing investment income from abroad will tend to offset whatever reductions in the trade balance may be achieved.

Guiding Policy by Economic Indicators?

The debate on policy coordination has continued to stress the use of economic indicators—including growth and inflation rates, money supply, fiscal deficit, the external balance, and exchange rates—as guides to "multilateral surveillance" of each country's policies. Use of these tools, the IMF has noted, could "strengthen the basis for assessing the international repercussions" of policies and policy objectives. In case of "significant deviations" from projected targets, the 1986 Tokyo communique declared, the seven countries' finance ministers and central bank heads would "make their best efforts to reach an understanding on appropriate remedial measures." The Venice declaration basically reaffirms that commitment.

Chart 4
Current Account Balances
(Billions of Dollars)



In a February, 1987, study *(Strengthening the International Monetary System,* Occasional Paper No. 50), the IMF sorted out the various available indicators and their potential scope. The study distinguished between three types of indicators: (1) those of economic performance, covering "the more fundamental objectives of economic policy," such as growth, unemployment, and balance-of-payments and price stability; (2) those of economic policy, namely "variables over which the authorities have fairly close control," such as monetary growth, exchange market intervention, and the fiscal deficit; and (3) intermediate variables, such as savings and investment, and interest and exchange rates—that is, variables that respond to policy and thereby can influence performance. With the emphasis currently placed on the international interactions and repercussions of national economic policies, any analysis would necessarily have to focus on policy indicators.

But we probably are quite a ways from fashioning sets of indicators for the major countries that would ensure implementation of mutually consistent policies. There are a number of points that have to be cleared up first. These include development of a mechanism for collecting and analyzing national forecasts on a strictly comparable basis; establishment of criteria for judging the consistency or "harmony" of individual national policies and objectives; and agreement on negotiating procedures when actual developments diverge from targets. Thus, progress toward a systematic use of indicators can only be very gradual.

In fact, one basic obstacle to achieving policy coordination is disagreement over the way the economic system and individual economies function and especially over the mechanism by which economic policies are transmitted. As Robert Solomon of the Brookings Institution has pointed out, countries need to agree not merely on policy goals, but also on a common view "of how the world works—that is, what happens when you push a given lever."

The Conference Board
845 Third Avenue, New York, N.Y. 10022 / 759-0900
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
Avenue Louise, 207-Bte 5; B-1050 Brussels, Belgium

Prepared by John Hein, Economic Analysis Program, Eric J. Kruger, Director. Reproduction permissible with full citation to The Conference Board as source. Published quarterly at 845 Third Avenue, New York, New York 10022.